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Enabling poor rural people  
to overcome poverty

## **Regulatory issues concerning the Credit Union of IFAD Employees:**

### **Managing risk related to the Credit Union**

#### **Note to Executive Board representatives**

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Executive Board — 103<sup>rd</sup> Session  
Rome, 14-15 September 2011

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**For: Approval**

## Recommendation for approval

The Executive Board is invited to endorse the recommendation contained in section VII.

### Executive summary

1. This paper presents to the Executive Board the significant risk situation of the Credit Union of IFAD Employees (Credit Union) and solicits comments from the Board so that Management may prepare proposals for a decision at a subsequent session.
2. The creation of the Credit Union and its subsequent evolution is the focus of this presentation. Management's views and position have been shared with the Board of Directors of the Credit Union (CU BoD); and CU BoD's comments are contained in section IV.
3. The circumstances under which the Credit Union was set up are described herewith, including constituent documents and the initial conditions offered to the Credit Union by the Executive Board.
4. Since its inception, the Credit Union has developed and evolved. An analysis of its current structure and an assessment of the methodology employed as a deposit-taking institution are provided below. Throughout this assessment, Management has actively sought the participation of the CU BoD.
5. By means of a review initiated by Management in 2009 following the global financial crisis, a working group was set up to consider the Credit Union's investment processes and, consequently, analyse IFAD's financial risk management procedures. The findings and main concerns of the working group are also described herein.
6. Particular attention is placed on the need for both prudential and integrity supervision of the Credit Union, in light of recent international developments and the specific and unique characteristics of IFAD and its Member States.
7. Cognizant of the need to address the concerns put forward herewith, options have been developed for discussion by the Board and a recommendation for further analysis is presented.

### I. Introduction

8. This paper outlines the historical background that led to the creation of the Credit Union and summarizes the Credit Union's progression over the years. It then discusses concerns regarding the Credit Union's existence and future in section III. This includes an analysis of the Credit Union's current status and highlights issues for discussion and areas for improvement in its management. The views expressed by the CU BoD are presented in section IV, and the paper concludes by presenting options to the Executive Board with regard to the Credit Union's future.

### II. Background

9. In March 1979, all IFAD staff members were granted access to the Credit Union of the Food and Agriculture Organization of the United Nations (FAO). This membership was discontinued as of 31 March 1986 when FAO determined that it needed to restructure its credit union to minimize risks inherent in its management. From 1986 to 1992, the President of IFAD requested FAO on various occasions to consider allowing IFAD staff to resume their membership in the FAO Credit Union, however, FAO did not accept to do so.

10. In light of the above, the President of IFAD requested the Executive Board to consider establishing a credit union for IFAD employees. The Board approved the establishment of the Credit Union at its forty-sixth session and also authorized various forms of support, including: (a) an initial start-up grant of US\$50,000; (b) permission for IFAD staff members to perform investment functions and other duties for the Credit Union during normal working hours; and (c) funding for the recruitment and employment of a Credit Union manager for an initial period of three years.<sup>1</sup> Furthermore, at its forty-seventh session, the Executive Board approved the extension of a line of credit to the Credit Union, which was set at 50 per cent of IFAD's accumulated liability for staff termination entitlements, then estimated at US\$6.4 million.<sup>2</sup> At its fifty-eighth session, the Board adopted the recommendation that IFAD (i) maintain the upper limit of the line of credit extended to the Credit Union at the then-existing level of 50 per cent of IFAD's liability for staff termination entitlements, and (ii) provide funding to cover 33 per cent of the Credit Union manager's salary and benefits in the financial years 1997 and 1998.<sup>3</sup>
11. The Statutes of the Credit Union of IFAD Employees, approved by the Executive Board at its forty-sixth session, defined the Credit Union as being "within the framework of IFAD" but being "operated by a Board of Directors".<sup>4</sup> Subsequently the Executive Board recognized that the provisions of articles IX (Freedom from Taxation), X (Financial Facilities) and XV (Officials of the Fund) of the Headquarters Agreement between the Italian Republic and IFAD also applied, *mutatis mutandis*, to the operation of the Credit Union.<sup>5</sup>
12. The Credit Union was set up to "encourage thrift by providing a convenient means of saving and to provide credit for emergency needs and for the general benefit of its Members".<sup>6</sup> As at 31 December 2010, the Credit Union had 637 members, total assets of EUR 42.5 million and total loans of EUR 5.7 million.
13. The Statutes provide that the funds of the Credit Union shall normally be invested in loans to members.<sup>7</sup> However, where the funds available exceed the amount needed for such loans, the CU BoD may invest the excess in such manner as it may determine, having due regard to the security of members' savings.
14. Separate accounts are maintained with the global custodian to ensure accurate accounting and reporting of Credit Union investments and the Financial Statements of the Credit Union are audited on an annual basis by an external independent auditor.
15. Until June 2009, a minor portion of Credit Union investments were pooled with those of IFAD.<sup>8</sup> As a result, IFAD's Treasury Division and its then Financial Division would calculate, on a monthly basis, the interest earned on each portion. The closing balance for both the Credit Union and IFAD would be split, reconciled and reported on a monthly basis.
16. In June 2009, the Credit Union approved a change in the liquidity management of its assets. It established that the Credit Union manager would be responsible for monitoring the Credit Union's short- and medium-term liquidity needs and would manage liquidity using money market accounts (MMAs). All Credit Union time deposits would be entirely funded by Credit Union funds, eliminating exposure of IFAD's assets.

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<sup>1</sup> EB 92/46/C.R.P.1.

<sup>2</sup> EB 92/47/R.94. The line of credit was used once in 18 years of operation during the initial start-up period (1993-1994) of the Credit Union and was repaid with interest.

<sup>3</sup> From 1999, the CU BoD decided not to request further funding for any part of the manager's salary and benefits. The Credit Union has been self-supporting since then.

<sup>4</sup> Statutes of the Credit Union of IFAD Employees, section 1.01.

<sup>5</sup> *Ibid.*, section 1.02.

<sup>6</sup> *Ibid.*, section 1.03.

<sup>7</sup> *Ibid.*, article IX.

<sup>8</sup> Ranging from 2 per cent to 9 per cent of Credit Union investments.

17. Currently, with the exception of the MMA transactions, the Credit Union, through its investment committee, provides its instructions on investments (currently pertaining to the maturity, currency and target interest rates of time deposits) in writing to IFAD's Treasury Division (TRE). According to those instructions, TRE selects and purchases the best time deposits available from IFAD's eligible banks so that those investments made on behalf of the Credit Union also benefit from a similar level of security, liquidity and return as IFAD's short-term investments. This is based on a mutual understanding between IFAD and the Credit Union that the latter's investment policy should fall within the same risk appetite as IFAD's.
18. In making investments on behalf of the Credit Union, TRE makes its best effort to fulfil investment instructions received from the Credit Union, with due regard to potential financial risk or impact on the Credit Union.
19. In establishing the Credit Union, the Executive Board enabled it to operate independently from IFAD Management. Indeed the statutes provide that "IFAD shall neither be liable for any financial losses of the Credit Union nor shall it be held responsible for any action of the Credit Union".<sup>9</sup>
20. The Board's intention was to create a credit union accountable to its members only, not to IFAD or its management.<sup>10</sup> However, it was also essential to the Executive Board that the Credit Union operate in compliance with IFAD's Headquarters Agreement. A provision to this effect was introduced in the statutes.<sup>11</sup> Pursuant to this provision, it is of utmost importance that IFAD's reputation not be jeopardized by the activities carried out by the Credit Union.
21. The statutes are not flawless, however, and two further provisions seem to contradict the Executive Board's intention:
  - (a) The first is article 10.2, pursuant to which amendments to the statutes may be prepared by the CU BoD or by members of the Credit Union and shall be approved by at least two thirds of the members present and voting at an annual or extraordinary general meeting at which there is a quorum;
  - (b) The second is article XI, pursuant to which the existence of the Credit Union may be terminated by voluntary liquidation. Such voluntary liquidation shall be carried out if at least three quarters of those voting in a referendum vote in favour of such liquidation, provided, however, that the total of the votes cast is equivalent to at least two thirds of the members of the Credit Union.
22. The question is whether these provisions sever the link between IFAD and the Credit Union. The answer is that they do not.
23. Moreover, in accordance with whichever option is selected as the way forward for the Credit Union (see section VI below), the Statutes will need to be redrafted as a matter of priority, with particular attention being given to articles X and XI, to ensure that they reflect the Executive Board's intention.

### III. Management arrangements

24. In May 2009, in the wake of the international financial crisis and with a view to establishing the entity of the role IFAD plays in the investments of the Credit Union, the investment processes followed by IFAD for Credit Union investments and IFAD's financial risk management procedures, a working group was established to

<sup>9</sup> Ibid., section 5.02(b).

<sup>10</sup> "All costs incurred in the operation of the Credit Union and any financial liabilities including bad debts and losses, arising out of the Credit Union's activities shall be chargeable and limited only to the funds and assets of the Credit Union" (ibid., section 3.02).

<sup>11</sup> "If, at any time, the President of IFAD is of the opinion that the Credit Union is or may be conducting its affairs in a manner that adversely affects the interest of IFAD under the Headquarters Agreement, he may request the Board of Directors to take action. In the event that such corrective action is not taken within a reasonable period, the President of IFAD may use his powers under the Headquarters Agreement to exclude the application of the privileges and immunities thereunder from applying to the action or actions that contravene the Headquarters Agreement." (ibid., section 5.02(a)).

elaborate and present recommendations to Management to ensure that IFAD's interests were safeguarded.

25. In 2010, having thoroughly analysed the governance, investment and administrative arrangements between IFAD and the Credit Union, a final report on the Credit Union was presented to Management.
26. The main concerns raised in the final report on the Credit Union that this paper will address are: (i) that the Credit Union is not subject to any prudential supervision and integrity supervision; and (ii) in the current setting, IFAD may be exposed to both liability risks and reputational risks.
27. Notwithstanding the explicit recognition by IFAD that the Credit Union acts within the framework of IFAD itself, the provisions of articles IX, X and XV of the Headquarters Agreement apply, mutatis mutandis, to the operation of the Credit Union. This should not be seen as exempting the Credit Union from the need for prudential supervision as well as integrity supervision.
28. Both the report and an opinion of the General Counsel of IFAD, issued in December 2009 (see annex), recommend that the above concerns be brought to the attention of the Executive Board in order for the Board to remedy the situation.

#### **IV. Views of the Credit Union Board of Directors**

29. The CU BoD has expressed its views with respect to this paper, which are summarized below.
30. In the view of the CU BoD, the purpose of this paper should be to inform the Executive Board of IFAD Management's concerns regarding the adequacy and appropriateness of the Credit Union's oversight and governance structure in light of its historical background and the current financial context in which it operates. To this end, the paper should provide an overview of both actions taken to date and those on-going towards understanding and improving the Credit Union's risk management/oversight, and developing appropriate and concrete proposals for the Executive Board's decision in 2012.
31. An inter-divisional IFAD working group (WG) was established in April 2009 to review issues pertaining to the governance, investment management, administrative arrangements, oversight and other issues relating to the Credit Union. The WG was chaired by LEG and worked closely with representatives of the CU BoD.
32. The draft report was finalized by the WG and submitted to the Chief Finance and Administration Officer (CFAO) in July 2009. Further consultation and revision was carried out by IFAD Management (including the Investment, Finance and Asset Liability Management Advisory Committee (FALCO) in January and June of 2010, and the Investment and Finance Advisory Committee (FISCO) in July 2010) and the final report was issued to the CU BoD in July 2010.
33. The main concerns raised in the report included: (i) whether the Credit Union is subject to adequate prudential and integrity supervision oversight; and (ii) in the current financial context, IFAD's possible exposure to both liability and reputational risks. IFAD Management wishes to ensure that the explicit recognition by IFAD that the Credit Union acts within the framework of IFAD itself (specifically that the provisions of articles IX, X and XV of the Headquarters Agreement apply, mutatis mutandis, to the operation of the Credit Union) is not perceived as or in reality is exempting the Credit Union from the need for prudential and integrity supervision.
34. Both the WG report and the opinion of the General Counsel of IFAD (see annex) recommend that the above concerns be brought to the attention of the Executive Board in order for the Board to consider and approve as necessary any actions needed to address these concerns.

35. In September 2010, the CU BoD provided Management with an Action Plan outlining recommended actions, actors and timeframes for completion of 19 of the 23 recommendations made in the report of the WG. Further meetings of the IFAD WG were finalized in November 2010 to clarify the four remaining recommendations.
36. Since September 2010, the CU BoD has been actively engaged in completing the necessary actions to implement the recommendations and has made significant progress with 14 of the recommendations already closed, 7 in progress and 2 placed on hold by the (former) CFAO. The CU BoD has requested permission to provide a progress report to keep Management informed of actions taken. The CU BoD reviews progress on the implementation efforts at its monthly Board meetings. Considering that the CU BoD is a completely volunteer group and serves the CU membership in their spare time, this level of progress is indicative of the serious commitment of the CU BoD to support IFAD Management in ensuring that CU operations adhere to best practices and that risks are adequately managed.
37. The CU BoD proposes additional steps to study possible options and formulate recommendations for the establishment of more robust oversight mechanisms for the Credit Union, to be presented to the Executive Board in 2012:
  - (a) Expediting implementation of the remaining recommendations of the WG report, most of which directly contribute to improved risk management;
  - (b) Engaging external expertise to perform an independent external review of Credit Union operations and structure in order to provide assurance to both IFAD Management and to Credit Union membership as to the current state of its affairs and to assess Credit Union alignment with best practices. The outcome of the review, to be completed by end 2011, would provide a well-informed basis on which IFAD and the Credit Union may define necessary actions to better align the Credit Union with best practice and to evaluate options for presentation to the Executive Board;
  - (c) Continuing consultations with other United Nations credit unions and Italian reference banks to gain more knowledge regarding good practices and the applicability of banking regulatory controls on credit union transactions as part of the process of evaluating the options for proposal to the Executive Board;
  - (d) Redrafting, as a matter of priority, articles X and XI of the Statutes, in consultation with IFAD Management to ensure that they correctly reflect the Executive Board's intention and remove any perception that the Credit Union is exempt from the need for prudential and integrity supervision; and
  - (e) Revising further the rules and practices of the Credit Union to reduce risk. The CU BoD has already adopted the use of a risk register to better identify and monitor relevant risks.
38. Following the completion of the steps mentioned above, the CU BoD would be in favour of establishing a joint CU BoD and IFAD Management working group to determine additional changes/improvements to be made to Credit Union operations/structure. Also, the joint working group would draft and finalize a decision paper for the April/May 2012 Executive Board.
39. In addition to providing the necessary information to formulate recommendations for consideration by the Executive Board in 2012, the CU BoD believes that in the short term, the steps above will further strengthen existing controls and supervision and support risk reduction activities already under way in the Credit Union. With regard to the issues raised in this document, the CU BoD believes that it is premature to consider specific options until completion of a more in-depth review of the current supervisory arrangements and a relevant assessment of the actual level of potential risk exposure.

## V. International developments

40. Since the establishment of the Credit Union, an international consensus has developed that all deposit-taking financial institutions should benefit from prudential and integrity supervision.

### Prudential supervision

41. Prudential supervision, which aims to protect the depositors, is ordinarily done at the national level by the central bank or an equivalent public authority. Indeed a central bank may require that financial institutions regularly review their overall capital needs to ensure that their capital base can support the estimated financial risks and needs of its business, thereby minimizing liquidity needs.
42. The international standards for prudential supervision are developed by a committee of central banks within the framework of the Bank for International Settlements. This committee developed the first set of standards establishing minimum capital requirements for internationally active banks in 1988, called the Basel Accord (Basel I). In 2004-2005, Basel II - "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" was established. Basel II is built on three pillars: (i) minimum capital requirements (credit risk, market risk and operational risk); (ii) supervisory review; and (iii) market discipline (detailed compulsory requirements).
43. Operational risk, of particular concern in the present discussion, is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Operational risk includes legal risk but not strategic or reputational risk. Examples of operational risk contemplated by Basel II include: internal fraud, external fraud, loss from and compensation for wrong employment practices and workplace safety, losses from negligent client product or business conduct (breaches of fiduciary duty, privacy, confidentiality, disclosure, money laundering and bad advice), damage to physical assets for natural disaster, vandalism, terrorism, business disruption or system failures, negligent reporting and incomplete documentation.
44. This paper is concerned mostly with the second pillar of Basel II, supervisory review. This entails how supervisors will review banks and check that the supervised are supervising themselves properly. There are four basic principles to this pillar: (i) banks must have procedures for maintaining capital; (ii) the supervisors should review bank capital procedures; (iii) banks should operate above the minimum capital; and (iv) supervisors should intervene early.
45. Prudential supervision is internationally accepted and should apply to all banks. The reason prudential supervision should be extended to the Credit Union is to be found in its practices. The international community's key consensus, determined by the analysis of international accords and case law, is that a bank is an entity whose business is to borrow money (deposits, which are repayable in full) from the public in order to lend the money to others and for its own account. By way of example, in the European Union, the recast Banking Consolidated Directive 2006 defines a credit institution as an undertaking whose business is to receive deposits or other repayable funds from the public to grant credits for its own account. In essence, an entity to which prudential supervision must be extended is one that borrows money to lend to others and who acts as an intermediary. Such is the nature of the Credit Union.
46. Therefore, putting in place an effective supervisory framework will ensure that the Credit Union is liquid even during episodes of market stress when liquidity is frozen over several asset classes. To put in place such a prudential framework would protect Credit Union members by ensuring that the Credit Union is able to meet their capital needs as and when they arise, balancing between its assets and liabilities to conduct core business activities.

47. A second aspect that needs consideration and that is directly linked to prudential supervision is integrity supervision. Risk management is enhanced by having effective integrity supervision over financial institutions.

#### **Integrity supervision**

48. A priority within the international community has been the fight against money laundering and the financing of terrorism. In response to mounting concern over money laundering, the Financial Action Task Force on Money Laundering (FATF) was established by a Group of Seven (G-7) Summit held in Paris in 1989. Recognizing the threat posed to the banking system and to financial institutions, the G-7 Heads of State or Government and the President of the European Commission convened this task force from the G-7 member States, the European Commission and eight other countries. The FATF has currently reached a membership of 34 member States. It works in close cooperation with other key international organizations such as the International Monetary Fund, the United Nations, the World Bank and various regional bodies.
49. Following the terrorist attacks of September 2001, the FATF expanded its mandate beyond money laundering to address the financing of terrorism and provided additional recommendations to complete those it had already provided on money laundering.
50. Indeed, it is acknowledged that money laundering, fraud and the financing of terrorism are global problems. In view of this, integrity supervision is advised to ensure that the Credit Union is not exposed to this risk but that it promotes policies and rules to combat these ills.
51. The United Nations has demonstrated its commitment to fighting the global challenges imposed by money-laundering, fraudulent and terrorist-linked activities by developing relevant international instruments, which include: (i) the United Nations Convention Against Transnational Organized Crime (2000); (ii) the International Convention for the Suppression of the Financing of Terrorism (1999); and (iii) the United Nations Convention against Corruption (2003).

#### **IFAD Credit Union and national and international systems**

52. Member States of the United Nations (including IFAD Member States) that ratify the above-mentioned conventions are required to put legislation and effective measures in place in their territories to reduce the opportunities for these activities to occur.
53. The nature of activities carried out by the Credit Union could make it susceptible to these risks. It is therefore advisable that IFAD should be seen as having the same practices as its Member States in complying with international obligations and should put in place a framework that would prevent the Credit Union from falling prey to such eventualities.
54. It follows that, although countries may effectively implement prudential and integrity supervision mechanisms enforced by regulatory authorities established under relevant laws, the Credit Union structure escapes such a robust prudential and integrity supervision framework.
55. Furthermore, because the Credit Union was established under the framework of IFAD, it does not enjoy supervision by national banking and regulatory authorities, and, at the same time, it does not qualify as an international organization.
56. An ulterior consideration that needs to be made, in light of the establishment of the Credit Union under the framework of IFAD, is its exemption from the payment of national taxes as provided for by the Agreement Establishing IFAD, the Convention on the Privileges and Immunities of the Specialized Agencies, and the Headquarters Agreement with Italy. It has recently come to the attention of Management that members of the Credit Union have acted upon the belief that the relief from payment of taxes accorded to IFAD under the Headquarters Agreement should be



extended to the savings of IFAD employees as members of the Credit Union. Management has clarified the relationship and exhorted all members of the Credit Union to comply with the regulations of each Member State as deemed applicable for their residency and/or nationality. The risk that Credit Union members, by act or omission, do not comply with national legislation, as applicable to them in each case, with regard to the declaration of the interest matured on their savings and consequent payment of taxes where due, puts IFAD at a reputational risk before the Italian authorities and before all its Member States.

## VI. Options for the way forward

57. As stated earlier, there are currently no provisions in the Credit Union statutes to combat money laundering or the financing of terrorism, nor do the statutes provide for any prudential supervision mechanisms as is internationally required for all deposit-taking institutions.
58. Given the status of the Credit Union, established as a limb of IFAD by the Executive Board, it is incumbent upon the Fund to provide a system that ensures adequate prudential and integrity supervision over the Credit Union's activities, be it an internal or external entity. It is critical to ensure that the reputation of IFAD is not jeopardized by activities carried out by the Credit Union. More importantly, international law requires that the Fund does not enable or tolerate a situation that is out of step with governing international standards and that potentially can contribute to the violation or evasion of the laws of its Member States.
59. Therefore, notwithstanding the Credit Union's efforts to protect its members' savings and prevent money laundering, fraud and the financing of terrorism, IFAD is legally required to ensure that the activities that the Credit Union carries out are adequately supervised by establishing a mechanism for oversight that will ensure prudential and integrity supervision. Only the Executive Board, which established the Credit Union, is competent to establish such a body or special entity to (i) ensure that the Credit Union operates in compliance with international standards for prudential supervision and the prevention of money laundering and the financing of terrorism; and (ii) ensure that the activities of the Credit Union are conducted in line with the provisions of its statutes and confined to the purposes for which it was established; or (iii) establish any other mechanism by which the Credit Union should be operated.
60. In view of the above analysis, Management has considered various options to address the concerns laid out in this paper, and is presenting the below for consideration:
  - (a) **Maintaining the status quo.** The first option is to maintain the current structure of the Credit Union, but to carry out a serious revision of its statutes and the inclusion of any necessary amendments to reflect the need to implement prudential and integrity supervision in the Credit Union's activities. The Board of Directors would be entrusted with the task of determining a time frame both for the necessary amendments to the statutes and for the resulting implementation of prudential and integrity supervision mechanisms;
  - (b) **Creating a subsidiary body.** The second option is the creation of a subsidiary body, under rule 11 of the Rules of Procedure of the Executive Board, to supervise the activities of the Credit Union and implement prudential and integrity supervision mechanisms. This option requires a two-tier process: (i) the setting up by the Executive Board of a structure and rules of procedure for a subsidiary body, including selection criteria for appointment to the body; and (ii) the preparation of terms of reference for such a body, including reporting mechanisms to Management and the Executive Board;
  - (c) **Outsourcing.** The third option is to outsource Credit Union operations to an independent and competent body, which would be charged with the

responsibility of managing the Credit Union on behalf of its members. What is intended in this particular option is for a private commercial bank, registered in the country where IFAD is headquartered, to relieve the Credit Union of its functions, as it currently stands, and provide retail banking services to its members. This option implies transferring the activities of the Credit Union to a retail bank and therefore relieving the Credit Union accounts from any privileges and immunities that were due while its accounts were opened in the name of IFAD. This option also implies that any interest on savings will be automatically deducted according to the local/national banking regulations in place. Any tax declaration to be made by members will also need to take account of the national banking system;

- (d) **Merging.** The fourth option is to merge the Credit Union with another independent and competent entity that has experience in managing a credit union of United Nations employees. This option necessarily implies that Management carries out a study of eligible entities for this purpose and reports back to the Executive Board at its next session in order to determine the most favourable solution for both IFAD and members of the Credit Union. Management would like to put forward the candidature of the United Nations Federal Credit Union as a viable candidate to be considered for this purpose;
  - (e) **Winding down.** The final option is to wind down the Credit Union. A determination as to the means and a time frame for such an option would necessarily require that open discussions be entertained between the Credit Union and IFAD, in order to ensure a smooth and unhindered process.
61. **Re-engaging with the FAO Credit Union.** A fifth option considered by Management was to attempt to re-engage with FAO and offer to transfer membership from the IFAD Credit Union to the FAO Credit Union. As reported earlier, the President of IFAD discussed this possibility with FAO until 1992. Since that date, IFAD has made no further attempts to re-engage with FAO for this purpose. The General Counsel of IFAD raised this issue with the Legal Counsel of FAO during a bi-lateral meeting in June 2011, and received a response from FAO on this matter which concluded that, whilst "an agreement was concluded (in 1979) between the Fund and FAO allowing staff members of IFAD stationed in Rome to become members of the Credit Union (of FAO)...this agreement was terminated in 1985." In view of the above, "the integration of the IFAD Credit Union into the FAO Credit Union would not be consistent with the current policy to maintain a limited credit operation for the benefit of FAO staff members only. For this reason, it would be advisable that the option of integrating the IFAD Credit Union with the FAO Credit Union not be presented as an alternative to the Governing Bodies of IFAD."

## VII. Recommendation

62. It is recommended that, following comments received on this paper, the Executive Board approve that Management engage in carrying out a study to define an efficient and effective mechanism to addresses regulatory and management concerns highlighted in this paper, and present its final recommendation to the Executive Board at its 104<sup>th</sup> Session in December 2011.

**MEMO**

Enabling poor rural people  
to overcome poverty

**TO:** Kanayo Nwanze  
President

**FROM:** Rutsel Martha  
General Counsel, OL

**DATE:** 10 December 2009

**SUBJECT:** Questions regarding the adequacy of the regulatory framework of the Credit Union (CU)

#### Background

1. As part of the due diligence exercise undertaken in the context of the global financial crisis that ensued in the fall of 2008, management took the decision to review and assess the existing arrangements (legal, investment management, financial and administrative services) between IFAD and the Credit Union of IFAD employees, in a bid to improve risk management in line with the Fund's standard financial risk management procedures. Accordingly the Inter-Divisional Working group on the Credit Union, established pursuant to a decision of the Assistant President, FAD, dated 8 April 2009, has developed a report of its findings. I am writing this memorandum in my capacity as the President's Representative on the Board of Directors (BoD) of the CU and also in my capacity as General Counsel. My main concern is that currently the CU is not subject to any prudential supervision and integrity supervision. This situation exposes IFAD to both liability risks and reputational risks. I would therefore recommend that this problem be brought to the attention of the Executive Board in order for the Board to remedy the situation. The present memorandum contains an explanation of this assertion as well as some suggestions for remedial actions.

#### Legal Analysis

2. I have previously stated in my opinion of 9 October 2008, that to the extent that IFAD is involved in the management of the resources of the CU and does so without required diligence it could be held responsible for possible losses<sup>1</sup>. In my opinion of 21 November 2008 I addressed the narrow question of IFAD's responsibility for possible CU losses in case the CU's investment guidelines are not followed<sup>2</sup>. On that occasion I advised that if IFAD apply mechanically the instructions provided by the CU, IFAD shall have no liability whatsoever regarding the investments of CU's funds. The present memorandum addresses the more fundamental question of design responsibility, which was not considered in the aforementioned opinions. Pursuant to the powers conferred to it by Section 5 (c) of the Agreement establishing IFAD, the Executive Board agreed to establish the CU in response to the desire by IFAD staff to have access to a CU, a facility which is available to virtually all United Nations staff members around the world. The CU was formally established at the Forty-Sixth session of the Executive Board of IFAD in September 1992.

3. The purposes of the CU are to encourage thrift by providing a convenient means of saving and to provide credit for emergency needs and for the general benefit of its members. Pursuant to Section 1.01 and 5.01, respectively, of the Statutes of the CU (Statutes) approved by the IFAD Executive Board at the same session, the CU shall be within the framework of IFAD and shall be operated by the Board of Directors in accordance with the Statutes.

4. Notwithstanding that IFAD explicitly recognises the CU as being within the framework of IFAD itself, and the provisions of Articles IX (Freedom from taxation), X (Financial facilities) and XV

<sup>1</sup> IFAD's responsibilities in relation to the Credit Union – Memorandum to the President dated 9 October 2008.

<sup>2</sup> The Credit Union of IFAD's Employees' Investment Procedures – Memorandum to the President dated 21 November 2008.

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(Officials of the Fund) of the Headquarters Agreement between the Italian Republic and IFAD apply, *mutatis mutandis*, to the operation of the CU (Section 1.02 of the Statutes), this should not be seen as exempting the CU from the need for prudential supervision and integrity supervision.

*a. Prudential supervision*

5. Undeniably, no financial institution that attracts funds from private citizens should escape prudential supervision and integrity supervision due to the risks to which both the financial institution(s) and citizens are exposed and in order to safeguard primarily the interest of their respective creditors. Prudential supervision can be exercised in different ways. Ordinarily it is done at national level by the Central Bank being the regulator of financial institutions. The Central Bank, as lender of last resort, may levy a reserve requirement. The banking supervisor can impose liquidity requirements that oblige financial institutions to maintain a capital structure and funding policies that assure a minimum level of capital and market liquidity at all times. In addition, the Central Bank may require that financial institutions regularly review their overall capital needs to ensure that their capital base can support the estimated financial risks and needs of its business, thereby minimising liquidity risk. Liquidity risk occurs when there are timing differences between cash inflows from the businesses and cash outflows for business needs and maturing obligations. Therefore putting in place a similar effective supervisory framework will ensure that the CU is liquid even during occasional episodes of markets stress when liquidity freezes occur across several broad asset classes. Such a prudential framework protects creditors by ensuring that the CU is able to meet their capital needs as and when they arise, it balances between its assets and liabilities and it is able to conduct core business activities without drawing upon credit facilities or resorting to other external sources of financing.

*b. Integrity supervision*

6. Similarly regulators at national level facilitate and enhance risk management by having effective integrity supervision over financial institutions. The international community has made the fight against money laundering and terrorist financing a priority. The Financial Action Task Force on Money Laundering (FATF), a 34-member inter-governmental body established by the 1989 G-7 Summit in Paris has primary responsibility for developing a worldwide standard for AML and CFT. It works in close cooperation with other key international organizations, including the IMF, the World Bank, the United Nations, and FATF-style regional bodies (FSRBs). In order to identify steps that national governments should take to implement effective AML programs, the FATF issued a list of recommendations (40 Recommendations), which set out a basic, universally applicable framework of measures covering the criminal justice system, the financial sector, certain non-financial businesses and professions, and mechanisms of international cooperation. This international standard was thoroughly reviewed and updated in 2003. In the wake of the terrorist attacks of September 11, 2001, the FATF expanded its mandate beyond money laundering to address terrorist financing. An extraordinary FATF Plenary on the Financing of Terrorism, held in Washington, D.C. in October 2001, issued eight Special Recommendations on Terrorist Financing (subsequently expanded to nine) as a new international standard to supplement the 40 Recommendations. The work of the FATF, as well as the IMF's in AML/CFT efforts, has been encouraged by the G-7 and the G-20, most recently in the context of initiatives to address the 2008–2009 international financial crisis. This may involve the regulator monitoring financial institutions to ensure that no unlawful transactions are carried out by them. Financial institutions may also be required to report any suspected unlawful activity to the authorities for investigation and further action. Indeed it is acknowledged that fraud, money laundering and the financing of terrorism are global problems. In view of this, integrity supervision is needed to ensure that the CU is cushioned from such risk and that in fact it promotes policies and rules to combat them. The UN has demonstrated commitment towards supporting the fight against these global challenges through developing international instruments, including the UN Convention Against Trans-National Organized Crime (2000), the International Convention for the Suppression of the Financing of Terrorism (1999) and the UN Convention Against Corruption (2003). Member states (including IFAD member states) that ratify these conventions are required to put in place legislation and effective measures to reduce the opportunities for these activities to occur within their territory. It can reasonably be argued that the nature of transactions undertaken by the CU make it susceptible to these risks, as such risks are normally incurred by all other financial institutions and their various products. This being the case, IFAD should not be seen to be lacklustre to comply with international obligations applicable to its members; hence it must put in place a framework to prevent such eventualities.

obligations applicable to its members; hence it must put in place a framework to prevent such eventualities.

*c. The CU's status exempts it from supervision by national authorities*

7. At its Forty-Fifth Session in April 1992, in reviewing preliminary proposals for the establishment thereof, the Executive Board expressed concern as to the status of the CU under Italian Law. It is our understanding that the Executive Board relied on a legal opinion regarding the same subject prepared by FAO's external lawyers in 1985. While addressing the position of the Credit Union of FAO employees under the Italian legal system at the time, the external lawyers confirmed that the operations of the FAO Credit Union would be exempt from Italian taxation and that Italian banking laws and regulations would not apply to the Credit Union because of the Organisation's supranational character. In view of the fact that the CU of IFAD employees was created in conformity with the structure of the Credit Union of FAO employees, it follows that the provisions that preclude application of Italian law to the Credit Union of FAO employees i.e. the Organisation's supranational character will apply *mutatis mutandis* to the CU of IFAD employees. It appears to be the case that the intention of the Executive Board then was to extend application of privileges and immunities contained in IFAD's Headquarters Agreement to the activities of the CU of IFAD employees. It follows therefore that although countries have effective prudential and integrity supervision mechanisms that are enforced by regulatory authorities established under the relevant laws, the CU structure escapes such a robust prudential and integrity supervision framework and it is imperative that one is put in place.

8. Taking into account the fact that the CU is established by an organ of an international organisation (IFAD's Executive Board), it must be recognised that the CU cannot be deemed to be an international organisation in its own right, as it lacks basic elements which identify such organisations. Neither do the Statutes of the CU explicitly state that it enjoys juridical personality for the exercise of its functions and fulfilment of its purposes under any system be it domestic or international. Although at its Forty-Sixth Session, the Board after careful consideration of all the issues involved approved the establishment of the CU for IFAD Staff within the framework of IFAD, it was established to operate separate from the rest of IFAD (Section 1.01 and 1.02 of the CU Statutes). Further, as a consequence of the fact that the CU is a limb of IFAD it enjoys immunity from national law and the supervision by national authorities, despite the fact that it does not qualify to be an international organisation. In lieu of this the only regime competent to regulate the operations of the CU is IFAD Statutes. This is a significant divergence from what happens with the United Nations Joint Staff Pension Fund (UNJSPF), as indicated by the UN Secretariat in a legal opinion. It states that "The UNJSPF is an entity constituted within the United Nations and its assets are an integral part of the assets of the organisation and can in no way be considered as separate and distinct therefrom."<sup>3</sup> The United Nations General Assembly is entrusted with the responsibilities related to the consideration and approval of the budget of the United Nations. In this function, it decides upon both the form and the substance of the budget. On several occasions, it has set up separate funds and accounts which are nevertheless integral parts of the United Nations in all respects. Whether or not a separate fund or account is established for any particular programme or project is a matter of administrative and management convenience, sometimes reflecting the particular sources of funding or destinations of expenditures. Nonetheless, such separate accounting procedures, or administration and management of a Fund (such as the United Nations Children's Fund (UNICEF), United Nations Development Programme (UNDP), United Nations Emergency Force (UNEF), United Nations Environment Programme (UNEP), as well as the United Nations Pension Fund) separate from the General Account of the United Nations, are matters internal to the Organisation and in no way imply any juridical distinction between such separate account or fund and the general assets of the United Nations. The fact is that all Funds established by the United Nations must be seen as integral parts of the United Nations and their assets as integral parts of the global assets of the Organisation and are open to scrutiny and control of the General Assembly in a manner dictated by the United Nations Charter. A further indication of the integrity of the United Nations Pension Fund within the general assets of the Organisation is manifested by the nature and extent of control which the Secretary-General exercises over the Fund. Under Article 97 of the Charter, the Secretary-General is designated as Chief Administrative officer of the Organisation. In that capacity he exercises all the administrative functions delegated to him by the General Assembly, including the authority over investment, budgeting and expenditure of all assets of the Organisation in accordance with the Regulations of the Fund.

<sup>3</sup> UNJYB 1997, 242-244.

Therefore, although all the activities of the CU shall only be conducted in accordance with the establishing statutes, it is legally possible for IFAD to ensure that its activities are adequately supervised. Outside its Statutes, the only other entity competent to direct the functions of the CU is the organ that established it. It follows that in line with the mandate to establish the CU, the Executive Board should develop a mechanism for internal oversight such as a Supervisory Sub-Committee of the Executive Board or a special entity to ensure that the activities of the CU are conducted in line with the provisions of the Statutes of the CU and confined to the purposes for which the CU was established.

*d. The President's Representative does not provide an adequate alternative*

9. Your mandate to appoint a representative to sit as an *ex officio* member in the Board of Directors of the CU emphasises the role outlined in Section 5.02 (a) of the Statutes of the CU, "if, at any time, the President of IFAD is of the opinion that the Credit Union is or may be conducting its affairs in a manner that adversely affects the interests of IFAD under the Headquarters Agreement, he may request the Board of Directors to take action," failing which the President may, "...exclude the application of the privileges and immunities thereunder from applying to the action or actions that contravene the Headquarters Agreement." Although this highlights the role to be played by your representative in the BoD of the CU, it overstretches your responsibility: First, the CU is an organ of the Executive Board and it would be in order that any oversight function over the CU be exercised by the establishing organ of the CU or a body directly responsible to the establishing organ of the CU; Second, although the CU is a subsidiary organ of the Fund it is expected to operate independently and in full autonomy. Indeed, pursuant to Section 5.02 (b) of the Statutes, "IFAD shall neither be liable for any financial losses of the Credit Union nor shall it be held responsible for any action of the Credit Union". Furthermore, the system of a President's representative cannot fulfill this function due to the limiting factors mentioned, the diversity of services required and the technical nature of the services required to properly execute the function.

*e. IFAD's risks [and how to overcome them]*

10. *The responsibility to ensure adequate supervision of the CU remains with the Executive Board.* The Executive Board can decide to exercise this responsibility on its own, in which case it will require to revise the standards on capital adequacy and liquidity elaborated in Articles VI and VII of the Statutes of the CU. Evidently, there are no provisions on anti-money laundering and counter-terrorism hence the Statutes must be revised to include these two aspects. In addition to incorporating standards in the system, the Executive Board should designate a body to exercise supervision over compliance. In this regard the Executive Board can exercise two options: i) It can create a subsidiary body under Rule 11 of the Rules of Procedures of the Executive Board or assign those responsibilities to an existing subsidiary body such as the Audit Committee; ii) It can revise the prudential supervision standards in line with the capital adequacy framework and liquidity risk management principles stipulated in the New Basel Accord (2004). Similarly, the existing rules should be supplemented with rules on anti-money laundering and counter-terrorism.

11. It is imperative to take into account that because of its characteristic of holding members' deposits, the CU may be exposed to other unanticipated risks which may affect IFAD directly. This is illustrated by a decision of the Administrative Tribunal of the International Labour Organisation (ILOAT) where the Tribunal had to determine whether a former staff member who was a participant in the Provident Fund established by his employer, the Organisation for the Prohibition of Chemical Weapons (OPCW), was entitled to reimbursement of the losses he suffered on his invested capital further to his participation in the Provident Fund as a result of "mismanagement and lack of monitoring of the provident Fund" by his employer.

12. Just like the CU, participants who were staff members of the OPCW made contributions to the Provident Fund. The Fund was authorised, in accordance with the Fund Administrative Rules, to invest the resources "in line with established investment policies and guidelines," and eligible staff members were entitled to receive the net value of their contributions at the end of their service with the OPCW. Although, as is the case in the Statutes, the Charter and Administrative Rules of the Provident Fund exclude the Management Board of the Fund from any liability for any financial loss "in respect of the manner in which resources [...] are administered or invested, except in the case of "gross negligence or wilful conduct", the Administrative Tribunal held that the complainant was entitled

to compensation for loss sustained by him. The tribunal's reasoning is that, "OPCW did not take adequate measures to ensure regular monitoring of the performance of the Provident Fund and this contributed directly to the capital losses sustained by it and subsequently the complainant".

13. Further the tribunal held that, "It is not in doubt that an international organisation is under obligation to take proper measures to protect its staff members from physical injury occurring in the course of their employment. The same is true with respect to loss of or damage to their personal property. As a matter of principle, the same must be true of financial loss suffered in the course of their employment. Particularly where the loss is directly associated with participation in a fund established by the organisation and managed in accordance with rules which limit the participant's rights with respect to that fund." In summary, the OPCW was held to be in breach of its obligation to establish an effective system to monitor the performance of the Provident Fund and liable for the loss that occurred as a result of breach of its obligation.

#### Conclusion

14. Given the CU's status as a limb of IFAD, created by the Executive Board, it is incumbent upon IFAD to provide a system that ensures adequate prudential and integrity supervision over the activities of the CU. IFAD risks liability due to the design flaw in the system of the CU, i.e. the lack of an adequate mechanism for supervision. The current system of a President's Representative cannot compensate for such a system. While the argument that IFAD cannot be held responsible for the consequences of decisions thus made by the CU may hold as far as concerns the question of management of CU's funds, which will not be true if the loss can be attributed to the flaws in the supervisory mechanisms. It follows that in line with the decision to establish the CU within IFAD, as opposed to an entity under national law, the Executive Board should develop a mechanism for internal oversight such as a Supervisory Sub-Committee of the Executive Board or a special entity to ensure that the activities of the CU are conducted in line with the provisions of the Statutes of the CU and confined to the purposes for which the CU was established.

15. Moreover, it is critical to ensure that IFAD's reputation should not be jeopardised by the activities carried out by the CU. For these reasons the Executive Board should act to put in place a proactive oversight facility to ensure that the operations of the CU adhere to suitable prudential and integrity standards.